August 28, 2009

Michael,

I'm writing you to report conduct which I believe is illegal and violates the Code of Professional Responsibility (the "Code"). I strongly urge you to take action to stop these continuing violations before Moody's incurs additional legal liability or regulatory action. This is precisely the kind of conduct which I have repeatedly warned you and Moody's about.

First, at issue is Nine Grade Funding II ("NGFII"), a transaction rated by the Derivatives group. The sole tranche was originally rated **Baa2** on October 15, 2008. On January 15, 2009 the deal was upsized and additions were made to the portfolio (the "January Substitution"). Through a Rating Agency Confirmation ("RAC"), the Derivatives group approved the January Substitution. The rating on NGFII was placed on watch for possible downgrade on May 8th 2009 due to portfolio deterioration which the Derivatives group knew was going to occur during the January Substitution. On May 13th another portfolio substitution (the "May Substitution") was approved by the Derivatives group. The May Substitution displayed a reckless disregard for the true credit nature of the underlying collateral.

The January Substitution criminally violated rule 10b-5 of the Securities and Exchange Act of 1934 and the May Substitution violated the Code and created regulatory and civil liability for Moody's.

Second, on July 6th, 2009 the Derivatives group assigned ratings to two tranches of Sahara Finance Eur Limited ("Sahara EUR"), a $2.5 billion CDO of ABS. I believe that the ratings assigned to this transaction are clearly wrong and were assigned with reckless disregard for the truth. I strongly urge you to act now to stop a related USD transaction ("Sahara USD") from adding billions more of toxic assets to investors' balance sheets. The scale of the civil liability related to the Sahara deals has the potential to damage the company and cause severe harm to our shareholders.

Legal Standards

Regulatory.

Moody's, like any other market participant, is subject to Rule 10b-5 of the Securities and Exchange Act of 1934. As a prominent New York law firm wrote on Moody's behalf, "a rating agency would be liable if it knowingly published a report that falsely misrepresented its own evaluation of a security"[1]. The January Substitution does indeed constitute illegal actions where Moody's issued an opinion which was known to be wrong.

Moody's conduct in these cases could also run afoul of other regulations. For example, the newly enacted European Union regulations for rating actions require that a licensed agency maintain certain strict and robust procedures to manage conflicts of interest.

The European regulations also require an independent compliance function.[2] As I will describe below, I believe that your group's conduct in this matter has fallen far short of what is required for EU

[1] http://www.sec.gov/comments/s7-04-07/s70407-63.pdf p2

[2] "A credit rating agency shall establish and maintain a permanent and effective compliance function which operates independently." Regulation Of The European Parliament And Of The Council on Credit Rating Agencies, Annex I ("Annex I"), Section A, paragraph 4a.

licensing. Additionally, proposed legislation in the US also mandates an independent compliance function.

Civil Liability

Additionally, Moody's may be civilly liable for ratings originated from the Derivatives group. Generally, Moody's has employed a First Amendment defense in civil suits claiming damages for poor ratings. Courts have ruled that the First Amendment protects a speaker so long as they do not act with "actual malice". "The actual-malice standard requires the plaintiff to prove that the defendant made the statement with knowledge of its falsity or with reckless disregard of its truth." *Compuware Corp. v. Moody's Investors Services, Inc.* 499 F.3d 520 (quoting *New York Times v. Sullivan,* 376 U.S. at 279-80).

However, reckless disregard for truth can be shown by "the purposeful avoidance of the truth" *Harte-Hanks Communs. v. Connaughton*, 491 U. S. 657, 692. In that case a newspaper was found to have acted with actual malice when it failed to review information which was made available to it or to interview a key witness. The court ruled that a defendant cannot rely on the First Amendment protection when it purposely ignores information which is available to it.

As I shall describe in more detail, I have repeatedly given you the requisite Harte-Hanks notices regarding the quality and the veracity of the ratings issued by the Derivatives Group. A court may find that these detailed and repeated warnings about the ethics and the methodology employed by the Derivatives group would preclude the use of the First Amendment defense in any case involving the January Substitution, the May Substitution, Sahara or further ratings issued by the Derivatives group.[3]

Background

1. In September 2007, I stopped what I believed to be violations of securities laws in the Derivatives group. As a direct consequence of these actions, I was illegally retaliated against and lost my position and pay. I filed a formal complaint with you relating to this retaliation on September 12, 2008.
2. During 2008, the Derivatives group was working on modifications for all of their methodologies in light of their obvious errors. ABS CDOs rated "Aaa", for example, had caused hundreds of billions of losses for the world's financial institutions. The Derivatives group prepared the new ABS CDO methodology for use with any transaction (including structured notes) with other structured finance securities as underlying collateral (the "ABS CDO Methodology"). Once this was complete, I was asked by the Credit Policy group ("CP") to submit my comments regarding the new correlations.[4] I was asked by the CP since I was the former head of ABS CDOs at Moody's and the CP felt that it needed an unbiased expert opinion regarding the work which was produced by the Derivatives group. I was highly critical of the proposal and thought that it was irresponsible. I recommended that in light of their credit performance that ABS CDOs should not be rated at all. Unfortunately, this correlation approach

[3] Moreover, Moody's conduct in these instances is more likely to be termed "actual malice" when contrasted with the more reasoned policy around RMBS resecuritizations.

[4] These comments were contained in a series of emails between me, members of the CP and the head of Structured Finance between October 30th and November 4th 2008.

was approved in substantially the same form reviewed by me and would later be used in NGFII and Sahara.

3. Additionally, the Derivatives group was working on a new CLO methodology (the "CLO Methodology"). The general scope of this new methodology, including documented comments from CP was laid out by the late summer of 2008. The Derivatives group resisted the CP's more reasonable approach and counter-proposals were discussed by the two groups during the fall of 2008. On December 16th the two groups reached final agreement on all the major details of the CLO Methodology. The main change which would drive the rating downgrades is a 30% increase in the assumed likelihood of default for all corporate credits. Frequent analytics were performed during the course of the negotiations between the Derivatives group and CP, so the management of the Derivatives group had explicit knowledge of the effect of the CLO Methodology on current CLO ratings. The new approach was even incorporated into the new version (v2.5) of CDOROM.[5] This new version of CDOROMv2.5 was operational by late December, included all the relevant methodology adjustments and was broadly available internally.
4. We met to discuss your response to my complaint on October 29th 2008 and December 3rd 2008.[6] Despite the abundance of evidence, you did not find that the conduct mentioned in my complaint violated any law or provisions of the Code. During our meetings, I verbally warned you about the problems with the ABS CDO Methodology, the lack of independence of the CP and the conflicts of interest within the Derivatives group.
5. At the request of Moody's, I put these methodology concerns in writing in a series of emails dated January 9th, January 13th and January 23rd, 2009 (attached hereto and referred to as the "January 9th email", "January 13th email", "January 23rd email" and collectively as the "January emails").
6. When we met to discuss the January emails on April 17th 2009, you assured me that your team conducted an "extensive investigation" involving senior personnel and, yet, you found nothing wrong with the rating methodology or the credit policy process.
7. However, as the facts around NGFII and Sahara show, what you told me was incorrect.

NGFII

NGFII is a structured note primarily backed by CLOs and sponsored by Guggenheim Capital. It was originally rated on October 15, 2008. The rating was done by a team from the Derivatives group using the relevant ABS CDO methodologies (including the ABS CDO Methodology).

The governing documents of the transaction allow the sponsor to substitute underlying collateral with rating agency approval or RAC. Several such substitutions have been made since closing and two of which are the subject of this complaint. Exhibit 1 to this letter lists the portfolios of NGFII at various relevant periods, including the principal balances and public ratings.

The January Substitution.

[5] CDOROM is a CDO rating tool commonly used across a spectrum of transactions.
[6] The additional meeting was necessary because during our first meeting I expressed my shock at the skeletal investigation you had performed. I asked you to follow up on some very basic facts which you ignored during your previous investigation.

- The January Substitution violated Rule 10b-5 and the Code precisely just as I described in my warnings. In the January 13th email I stated that, "[P]otential [10b-5] liability stems from the severe and dramatic downgrades we are still seeing in the ABS world and is identical to the one I described in my [September 2008] complaint. … It would be disappointing if 10b-5 concerns were not incorporated into the new CDO methodology given the prior incident."[7]
- The January Substitution involved upsizing the NGFII transaction through the addition of several CLOs and issuance of an additional $60 million of notes with Moody's investment grade ratings.
- Prior to the January Substitution, the Derivatives group had already approved the changes the methodology with which it would rate corporate (CLO and synthetic) CDOs. This methodology was even implemented in the relevant rating tools such as CDOROMv2.5. In fact, even the *rating impact* of the CLO Methodology was known to the Derivatives group.[8]
- The very same day that the January Substitution had occurred, Moody's publicly announced future changes to the CLO methodology. In a press release entitled "Moody's updates key assumptions for rating corporate synthetic CDOs" the rating agency described the key provisions of the new changes including "a 30% increase in the assumed likelihood of default for all corporate credits in synthetic CDOs" and that "[t]he revised default probability assumptions will also be incorporated into Moody's CLO rating methodology; those changes will be announced shortly."[9]
- Yet, no adjustments were made to the analysis of NGFII for the January Substitution to compensate for the application of the CLO Methodology and to avoid issuing a fraudulent opinion.
- On March 4th 2009, the Derivatives group began "Stage I" of the implementation of the CLO Methodology by putting all CLOs on watch for possible downgrade. Stage I lasted only a few weeks. As a result, __all__ the underlying CLOs in NGFII were either downgraded or placed on watch. These actions were taken as a result of applying a methodology known to the Derivatives group at the time of the January Substitution.[10]
- Subsequent to the downgrades, the rating of NGFII was determined by the Derivatives group to be **Caa1** compared to the public rating of **Baa2**.[11] Unfortunately, the same conclusion should have easily been reached in January.
- Because Stage I was meant to be only "parametric" the **Caa1** rating does not even reflect the full deterioration of the portfolio approved by Moody's during the January Substitution. One of the tranches rated **Aa2** in at the time of the January Substitution was downgraded 8 notches to **Ba1** on July 8th 2009![12]

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7 Also, in the January 23rd email and speaking of the default probability stress and the potential of rating something about to be downgraded: "10b-5 liability may follow since Moody's would be falsely misrepresented its own evaluation of a security."

8 For example, an analysis on a sample deal run by the Derivatives group in early December showed that a current **Aa2** rating would fall to **Baa1** under the new CLO Methodology and a current **Baa2** rating would fall to **B1**.

9 "Moody's updates key assumptions for rating CLOs" February 4, 2009 states: "As announced in a press release for corporate synthetic CDOs dated January 15, 2009, Moody's increased its default probability assumptions for corporate credits (including financials) in reference pools of synthetic CDOs. Consistent with this change, Moody's has similarly increased its default probability assumptions for corporate credits in the collateral pools of CLOs by a factor of 30% across all rating categories.

10 "Today's rating actions, which affect approximately 3,600 tranches totaling $100 billion from 760 transactions, reflect the revision of certain key assumptions that the agency uses to rate and monitor CLOs." *Moody's puts all but senior-most CLO tranches on review for downgrade;* Press release, March 4, 2009.

11 As part of the May Substitution committee, held on May 12th 2009.

12 Hewett's Island CLO II, Ltd. Class A-2A. See the "The ABS CDO Methodology is Grossly Inadequate" of this letter section for more details.

- Moreover, it would have been easy for the Derivatives group to re-rate the underlying CDOs. I am intimately familiar with this process which is fairly straight forward and automated. The deal team would not have even needed to ask for help from another group – and most of the underlying securities were US CLOs,
- At the time of the January Substitution, the Derivatives group knew that the ratings of the underlying CLOs in NGFII were no longer valid due to the change in methodology. Furthermore, the group already knew the impact of the methodology on the ratings. Yet, the issuer was allowed to issue another approx. $60 million of notes with ratings that the Derivatives group knew falsely represented its own evaluation of the security.
- Based on the facts related above, the January Substitution is a clear violation of the Rule 10b-5.

The May Substitution

- The May Substitution also demonstrates the Derivatives group's reckless disregard for the truth and may have created legal and regulatory liability for Moody's Corporation.
- The May Substitution involved the removal by the issuer of many of the recently downgraded securities and their replacement with two tranches from a transaction known as Valleriite CDO ("Valleriite"). As a result, the S and the A1 tranches from Valleriite constitute over 80% of the principal balance of NGFII and making it effectively a re-securitization of Valleriite. Given this direct dependence, the Derivatives group needed to closely analyze the credit of Valleriite prior to approving the May Substitution.
- However, for the purposes of approving the May Substitution, no re-rating or review of Valleriite was undertaken. A committee held on May 12th 2009 for the May Substitution found that the rating of NGFII after the May Substitution was **Baa3**.
- Valleriite is a severely stressed hybrid corporate CDO rated in Europe. A quick perusal of the trustee report would immediately alert anyone as to the poor state of this transaction. For example, the March 2009 trustee report (available to the Derivatives group prior to the May Substitution) lists nearly $170 million of collateral in default or rated **Ca** and below.[13] Additionally, another $63 million of exposure was related to Ambac and MBIA, two very stressed monolines.[14]
- Unfortunately, the subordination to the Class A1 tranche, which now constitutes 36% of the underlying credit for NGFII, is only $187 million. Considering the low recoveries on the already defaulted assets and considering the prospects of the severely stressed monolines, the subordination to the Class A1 tranche has effectively been depleted. It is now the "first loss" piece of the transaction.
- As of the June 19th 2009 trustee report, just over a month after the substitution, the Valleriite Overcollateralization Test ("OC Test") was 98.90%, implying that the transaction is now undercapitalized.[15] The transaction will continue to deteriorate – the portfolio also contains over $27 million of net long **Ca**-rated CIT exposure. Given the erosion of the subordination, the actual rating of the Valleriite Class A1 tranche is likely to be in the **B** to **Caa** range.

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[13] See Exhibit 2 for details.

[14] Additionally, the Trustee was using incorrect ratings for the two monolines a fact that the ratings team should have discovered immediately.

[15] An OC Test measures the ratio of the transactions assets to its liabilities and is meant to improve the transaction's fortunes by restricting cash to the equity holder and paying off the rated bond holders instead. An OC Test below 100 indicates that there are now fewer assets than liabilities in a transaction. The OC Test language in Valleriite is also poorly drafted and the OC Test value should be much lower than the trustee is reporting.

- That is far below the current the investment grade rating of NGFII. These facts could have been easily discovered by the NGFII ratings team had they simply followed the standards set forth in Moody's policy for analyzing resecuritizations.
- The standard of care for resecuritizations (the "Resecuritization Standard") in another Moody's structured finance group is set forth in a press release dated September 22, 2008 which states:

> "Current adverse conditions in the U.S. housing and credit markets have placed considerable downwards ratings pressure on residential mortgage-backed securities (RMBS). The performance of loan pools underlying RMBS have experienced rapid deterioration, sometimes in as short a time period as a month.
>
> In light of these conditions, *Moody's announced that it will not assign a rating to any security issued by a resecuritization transaction backed by one or more RMBS without first reviewing the ratings (and, if appropriate, taking rating actions) on the underlying RMBS*, in addition to its normal surveillance of these underlying transactions." [Emphasis mine]

- I urged you to adopt a similar standard for the Derivatives group.[16] Yet, there was no effort by the Derivatives group to re-rate Valleriite to determine their final rating even when they knew the ratings were in flux.
- Furthermore, at the time of the May Substitution, the Derivatives group had just begun Stage II of the CLO review. During this period "additional rating actions will be taken as necessary for all rated liabilities, including tranches currently rated **Aa** and **Aaa**."[17] All four of the remaining CLO tranches were on watch for possible downgrade at the time of the May Substitution.
- Alternatives which could have easily pursued by the Derivatives group included waiting for Stage II to conclude or merely placing the affected deals ahead in the Stage II rating queue. Instead, a blanket and insufficient two-notch adjustment was applied by the rating committee.
- These facts show that Moody's acted with "actual malice" by purposely avoiding the truth easily available to the rating agency in trustee reports and by not following an effective policy applied to similar transactions in another group. Such a showing would allow a plaintiff to nullify a First Amendment defense.

The Causes of Poor Derivatives Ratings

I believe that the continuing poor performance of Moody's Derivatives ratings, even in light of the global credit crisis, is attributable to four primary factors. Three of these factors I have warned you about before and the last is new, a product of my interaction with the compliance group.

Continuing lack of management of conflicts of interest in the Derivatives group

I have repeatedly warned you about the conflicts of interest in the Derivatives group.[18] In fact, this conflict has gotten worse in recent months. Due to a lack of new "plain vanilla" transactions which

[16] From the January 13th email: "However, an ABS CDO is just a resecuritization backed by ABS including RMBS. The same concerns about rapid credit deterioration stated above apply equally to ABS CDOs since the underlying securities can be identical. Unfortunately, the only protection for investors under the new CDO methodology against "considerable downwards rating pressure" in the underlying assets is the default probability stress described in my previous email. … I cannot understand why given identical assets and the prudent concerns stated in the press release above, the re-rating approach is not used in the CDO methodology. I do not see any credit aspects that would justify these differences."

[17] "Moody's completes Stage I of CLO review" announcement from

[18] For example from the January 9th email, "As I have mentioned to you before, when I asked a former colleague about their

were common during 2008[19], I believe that the management of the Derivatives group has become desperate to generate revenue. This has led to the approval and rating of more complex and highly questionable transactions like NGFII and Sahara.

Additionally, the Derivatives group runs afoul of several violations of the Code, including section 1.15.[20] The behavior of the Derivative group with regard to NGFII and Sahara shows that I was indeed punished in the fall of 2007 for exposing the conflicts of interest and the illegal activities of the Derivatives group.

Instead of keeping a close watch on a group which has caused hundreds of billions of losses for global financial institutions and continues to display an irresponsible disregard for the quality of its ratings, no one at Moody's seems to be able to say "No" to the Derivatives group. This attitude is reckless and carries high risks for our clients and shareholders alike.

The Ratings Procedures are Inadequate

I warned Moody's as well that the procedures used by the Derivatives group lacked in rigor and may expose Moody's to liability.[21] There is no reason that the Derivatives group is not forced to adopt the review and re-rating approach like the Resecuritization Standard. As I pointed out to you before, there is no difference between RMBS securitizations and Derivatives transactions backed by other structured finance and there is no reason that a separate standard should apply.

Had the Resecuritization Standard been in place in the Derivatives group, the potential liability incurred by the May Substitution may have been avoided. The ratings team would have been forced to look at the Vallcriite transaction, instead of recklessly ignoring it. This quick and simple procedure would have forced the Derivatives group to own up to the truth that NGFII no longer maintains investment grade ratings.

The Derivatives group continues to recklessly flout procedures and take analytical short cuts in their quest for revenue. I believe that it is irresponsible for Moody's not to subject the group to the same minimum standards which exist in other groups.

The ABS CDO Methodology is Grossly Inadequate

I have repeatedly warned that the ABS CDO Methodology used by the Derivatives group is inadequate. In the January 9th email, I state: "As we have discussed twice before, the current methodology employed by the CDO group to rate ABS CDOs produces ratings which are misleading and, in my opinion, will continue to destabilize the financial markets as well as cause losses for investors and our shareholders." In my emails to the CP group, I recommended that ABD CDOs should not rated at all.

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rationale, the person answered, "well, we have nothing else in the pipeline." This shows that the primary motivation for the rating methodology is increasing revenue and not actual credit."

19 Primarily balance sheet transactions financed with central bank repo lines.

20 [Moody's] will hold its Employees to high standards of integrity. **MIS will not knowingly employ any individuals with demonstrably compromised integrity,** subject to applicable law. [Emphasis mine]

21 See the May Substitution, above

The experience of NGFII proves that I was correct. After the January Substitution, the transaction was rated **Baa2** and yet within a matter of months, the transaction needed to be downgraded to **Caa1** (according to the group's own calculations).

Moreover, the methodology fails to compensate for the "broad deterioration in credit quality across all asset classes".[22] For example, take the Class D tranche of Nob Hill CLO II – one of the tranches in the portfolio at the time of the January Substitution. The official rating at the time was **Baa2**. However, by June 12, 2009 the tranche was downgraded to **Ca.**

Another tranche which survived the May Substitution and currently resides within NGFII is the Class A-2A tranche of Hewett's Island CLO II. This tranche was rated **Aa2** at the time of the January Substitution and was on watch for downgrade during the May Substitution. Based on the ABS CDO Methodology, a rating of **A3** was used to approve the RAC during the May Substitution for this security. On July 8, 2009, the tranche was downgraded to **Ba1** – five notches lower than the feeble stresses which the Derivatives group subjected it to. Any reasonable methodology should take into account this type of credit volatility.

The ABS CDO Methodology clearly does not work. I have warned you and others at Moody's about this inadequacy numerous times, yet even after the experience of NGFII, no changes have been made to the ABS CDO Methodology. It continues to be employed in deals like Sahara. This lack of response to the clear evidence of the methodology's failure is the very definition of "purposeful avoidance for the truth". The ABS CDO Methodology should be immediately and publicly discarded.

The Credit Policy Group Lacks Independence

The NGFII incident also illustrates the weaknesses of the credit policy ("CP") function. I had warned you during our meetings that the CP personnel are precluded from performing their oversight functions by the business lines. The CP's role is largely ceremonial, intended to placate stockholders and regulators, but lacking any real ability to make changes to the way assets are rated.

NGFII is a product of this system. The ABS CDO Methodology was railroaded through the CP process without the required analysis. Despite the assurances to the public and to the regulators and the requirement of the Code, in the case of the ABS CDO Methodology, **no validation was performed by the CP group**. The CP was merely given a choice of accepting a bad methodology or continuing with the previous completely erroneous one.

Furthermore, the CP's impotence was evident by its lack of reaction to the massive downgrades of the Prime and Alt-A securities earlier this year. I referred to these downgrades in my January 9th email.[23] The severity of those downgrades (some **Aaa** were downgraded straight to single-**C**!) should have convinced any independent credit person that the stresses in the ABS CDO Methodology are insufficient. The ABS CDO Methodology would have only proscribed a one notch stress for securities that were in some cases downgraded 15-20 notches. The fact that nothing about the ABS CDO Methodology changed in the face of its demonstrated failure shows that the CP is has no real power when dealing with matters of methodology.

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[22] January 13th email

[23] "The [ABS CDO Methodology] default probability stress is completely inadequate. For example, the default probability stress for mortgage-backed **Aaa** will be 12 times. This places the **Aaa** at slightly below **Aa1**. How can you assign ratings based on this stress when the RMBS group has routinely downgraded **Aaa** multiple categories (see attached example) in one action? The new CDO ratings based on this stress will not be sufficient."

In order to provide protection against the conflicts of interest inherent in the "issuer-pay" rating agency model, an effective CP group and policies are required. NGFII demonstrated that such a function does not exist at Moody's. The business lines remain too powerful for a small group of even dedicated professionals to override.

The Compliance Group in not Independent.

The sad truth about the liability which Moody's now faces is that it need not have occurred. I have given your office repeated, detailed and concrete warnings about the problems with the Derivatives group.[24] Furthermore, my warnings were precisely on point – the Derivatives group acted exactly as I predicted they would.

On April 17th 2009, you summoned me to your office to give me feedback on the concerns stated in the January emails. You told me that you had conducted an extensive investigation involving many man-hours of work and found that nothing was wrong. You would not elaborate further on any specific concerns or the procedures you used to investigate.

Yet, your investigation failed to discover the facts around the January Substitution or to prevent the further violations of the May Substitution or Sahara. Without passing judgment on exactly what your office did to conduct the investigation, the problems are so obvious that your groups failure to act leads to only one conclusion – the compliance group is not independent.

As you know, the regulatory framework around managing conflicts of interest in the "issuer-pay" model relies heavily on the independence of the compliance group. For example, the licensing requirements for rating agencies in the European Union require that:

"4b. In order to enable the compliance function to discharge its responsibilities properly and independently, a credit rating agency ensures that the following conditions are satisfied:

(a) the compliance function must have the necessary authority, resources, expertise and access to all relevant information;..."[25]

Additionally, the proposed Investor Protection Act 2009 forwarded to Congress by the Obama Administration[26], requires the designation of a compliance officer who:

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[24] For example, from the January 9th email: "As we have discussed twice before, the current methodology employed by the CDO group to rate ABS CDOs produces ratings which are misleading and, in my opinion, will continue to destabilize the financial markets as well as cause losses for investors and our shareholders." and "Combined these factors, and others mentioned in the emails, produce ratings which are grossly misleading."; from the January 13th email: "The same concerns about rapid credit deterioration stated above apply equally to ABS CDOs since the underlying securities can be identical. Unfortunately, the only protection for investors under the new CDO methodology against "considerable downwards rating pressure" in the underlying assets is the default probability stress described in my previous email." from the January 23rd email: "We are in the beginning of a potentially severe global recession and many assets classes can suffer the same fate. It is illustrative that Alt-A assumptions have already been updated in May of 08, yet this recent update raised the loss estimates multiple times. It is likely that other asset classes will also suffer from broad and severe downgrades. A more robust approach is needed."

[25] Annex I, Section A

[26] http://financialstability.gov/docs/regulatoryreform/titleIX_subtC.pdf and with respect to the independence requirement similar to S.1073, the Senate bill on credit rating reform sponsored by Senator Reed of Rhode Island.

"(B) shall--

(i) review compliance with policies and procedures to manage conflicts of interest and assess the risk that such compliance (or lack of such compliance) may compromise the integrity of the credit rating process;

(ii) review compliance with internal controls with respect to the procedures and methodologies for determining credit ratings, including quantitative and qualitative models used in the rating process, and assess the risk that such compliance with the internal controls (or lack of such compliance) may compromise the integrity and quality of the credit rating process;"

And "(D) ensure compliance with securities laws and the rules and regulations issued thereunder, including rules promulgated by the Commission pursuant to this section."

Based on the set of facts which I describe above, your office failed in the tasks and standards required of the compliance officer by these regulations. These failures are critical to shareholders since they may cause Moody's to lose its licensing in the US or fail to be licensed to operate in Europe.

Sahara

On July 7th, the Derivatives Group assigned final ratings to Sahara EUR transaction.[27] This is another poorly rated transaction which may subject Moody's to further legal liability and regulatory action. This transaction constitutes approximately €2.5 billion of toxic assets from the balance sheet of Natixis, including an approximately a 20% bucket of other CDOs. Even after the clear NGFII failure, the ABS CDO Methodology was applied. There was no attempt by the Derivatives group to re-rate the portfolio and even in the middle of a publicly announced Stage II surveillance period too little was done to protect investors from the eventual downgrades.

This transaction was rushed through the rating process and many errors were made on the part of the rating team as well as the bankers. For example, some ratings are mis-stated and the bankers initially failed to properly report the maturities of the underlying collateral.

Worse, had slightly more realistic assumptions been made, the ratings would have been far worse. The Derivatives group knows this and when they applied more realistic assumptions based on recent experience (e.g. that mezzanine tranches have a zero recovery rate), the ratings drop dramatically.

However, the Sahara USD transaction, which was committeed at the same time as the Sahara EUR deal but did not yet close, is far worse. It is a multi-billion dollar CDO-squared – the worst creation of the credit bubble era. There are no independent credit professionals who believe that these deals can be analyzed or rated with any certainty. Unsurprisingly, the Derivatives group is willing to bless this transaction with a Moody's rating.

Moody's faces potentially significant liability and well as regulatory action for both of the Sahara transactions. I gave the rating agency repeated Harte-Hanks notices regarding the truth of the ABS CDO Methodology, which has also objectively failed in the form of NGFII. To continue to apply the ABS CDO Methodology constitutes actual malice on the part of Moody's.

Conclusion

I'm concerned that there are other "time bombs" in addition to Sahara which will increase Moody's liability, subject it to regulatory action and potentially endanger its status as a rating agency.

[27] Committees for the transaction were held on June 25th and 29th, 2009.

Furthermore, it is clear that the Derivatives group is not able to manage its conflict of interests. The NGFII and Sahara transactions demonstrate clearly that there are no other parties at Moody's who are able to police the Derivatives group. Issuing any further ratings by the Derivatives group under these circumstances may constitute "active malice" on the part of Moody's.

A court could find that any further ratings by the Derivatives group would constitute the purposeful avoidance of the truth by Moody's. In reaching its decision the court may take into account the history of the group's actions and Moody's management's response to them. The list would include my dismissal for bringing to light illegal actions by Derivatives group's management and Moody's sanction of the same; the group's repeated use of a failed rating methodology which has objectively shown itself to be inadequate and Moody's explicit consent to the same; the group's failure to follow simple procedures like the Resecuritization Standard used by other groups, etc. Moreover, a court may base its decision on the fact that Moody's management was explicitly warned about all of the above and purposely avoided taking any action to stop the violations.

In order to limit future damage to Moody's clients, shareholders and the financial markets in general, I believe that the management of Moody's should immediately prohibit the Derivatives group from assigning new ratings until such time as:

1. The substantial conflicts of interest and ethics issues plaguing the Derivatives group are finally resolved.
2. All of the methodologies used by the Derivatives group are reviewed by an independent outside third party for their adherence to the Code and the requirements of various regulations. All the assumptions and inputs need to be independently verified and validated to ensure their adherence to required legal standards and the Code.
3. Rating procedures are independently reviewed to make sure that they do not cause Moody's to violate the law. Immediately enforce the Resecuritization Standard in the Derivatives group.
4. As required by various regulations, the CP and Compliance groups are made truly <u>independent</u> of the business lines.

The unfortunate fact is that had Moody's taken my complaints seriously and conducted an independent investigation the violations described above would have been avoided. Instead, Moody's has purposely avoided the truth with respect to the Derivatives group and the ABS CDO Methodology. As required of me by the Moody's Code of Business Conduct and specifically requested by you, I will continue to report to you any violations of the law, regulatory requirements or the Code. However, if Moody's fails to take action regarding these violations, I may be required to report my findings to relevant governmental and regulatory bodies for review.

Sincerely
Eric

Addendum

Michael,

Since I gave you a draft version of this report during our meeting on July 28th 2009, there has been another development with NGFII. Unfortunately, like the previous ones, this one also involved reckless disregard for the truth.

On July 31st 2009, a Moody's rating committee approved yet another portfolio change for NGFII (the "July Substitution"). This change involved the removal from the portfolio of all of the collateral other than Valleriite and simultaneous pay down of the rated notes. After the July Substitution, the only assets remaining in NGFII were the two tranches from Valleriite.

A transaction backed by only one or more tranches from the same transaction is the classic definition of "resecuritization" and, yet, the Derivatives group failed to follow the Resecuritization Standard. In fact, the group failed to even open the related trustee report. This action, which would literally have required an analyst to click a mouse five or six times, would have shown that the transaction is seriously undercapitalized. As I mentioned above, as of the June 19th 2009 trustee report (available to the analysts at the time of the July Substitution) OC Test was 98.90%.[28] Furthermore, prior to the July Substitution, Ambac and CIT were both downgraded to Ca. The two credits account for over $75 million of net long exposure for Valleriite. It was reckless of the team not to determine the effect of these downgrades on the ratings of am already distressed Valleriite and, by extension, NGFII.

Another troubling aspect of NGFII is the closeness of the cooperation between the issuer and the Derivatives group. I believe that there have been at least 4 portfolio substitutions since closing, involving, at times, note upsizings and pay downs. Each one of these has been actively approved by Moody's. I believe that a good argument can be made that Moody's is acting as an investment advisor for NGFII and not just an independent third party arbiter of credit. This could potentially create more liability for Moody's.

I am disappointed, but not surprised, that you have failed to do anything about the conduct of the Derivatives group even after the receipt of the draft version of this report. I believe that an independent compliance office would have at least put a hold on further rating activity with respect to this credit until the matter is resolved.

[28] See "May Substitution", above

Exhibit 1

		As of Oct 2008		As of Jan 2009		As of May 12, 2009		Initial Dwg	Further Rating Changes	
Deal Name	*Tranche*	*Balance*	*Rating*	*Balance*	*Rating*	*Balance*	*Rating*	*Date*	*Rating*	*Date*
DFR Middle Market	B	1,000,000	Aa2	1,000,000	Aa2	1,000,000	Aa2/*-	3/4/2009	A2	7/20/2009
GE Business Loan	A	-	Aaa	1,790,376	Aaa	1,790,376	Aaa			
Hewett's Island CLO II, Ltd.	A-2A	-	Aa2	3,000,000	Aa2	3,000,000	Aa2/*-		Ba1	7/8/2009
Latitude CLO III Ltd.	C	-	Aa2	4,500,000	Aa2	4,500,000	Aa2/*-			
Prospero CLO I B.V.	A2	-	Aa2	7,500,000	Aa2	6,588,521	Aa2/*-			
Black Diamond CLO 2005 -2	B	-	Aa2	8,000,000	Aa2	-	Aa2/*-			
CIFC Funding 2006-I, Ltd.	A3L	-	A2	5,000,000	A2	-	Baa3/*-	3/23/2009		
CIFC Funding 2006-I, Ltd.	A2L	-	Aa2	8,000,000	Aa2	-	Aa2/*-			
Duane Street CLO IV, Ltd.	D1	-	Baa2	5,500,000	Baa2	-	Ba3/*-	3/13/2009	Caa2	6/9/2009
Emporia Preferred Funding II	D	4,500,000	Baa2	4,500,000	Baa2	-	B1/*-	3/23/2009		
Emporia Preferred Funding III	D	7,750,000	Baa2	7,400,000	Baa2	-	Ba3/*-	3/23/2009		
FM Leveraged Capital	D	8,000,000	Baa2	8,000,000	Baa2	-	B1/*-	3/17/2009	B1	7/22/2009
Galaxy VI CLO, Ltd.	B	-	Aa2	9,000,000	Aa2	-	Aa2/*-	3/17/2009	Baa1	7/22/2009
Nob Hill CLO II, Limited	D	4,250,000	Baa2	4,349,704	Baa2	-	B3/*-	3/13/2009	Ca	6/12/2009
Pacifica CDO V, Ltd.	A2	-	Aa2	9,000,000	Aa2	-	Aa2/*-			
Valleriite CDO I Plc	A1	-	Aaa	-	Aaa/*-	31,000,000	A3	4/16/2009		
Valleriite CDO I Plc	S	-	Aaa	-	Aaa	38,000,000	Aa1	4/16/2009		
	Total	**25,500,000**		**86,540,080**		**85,878,897**				

Exhibit 2

Defaulted Obligations	Principal Amount
KAUPTHING BANK HF	7,955,893.46
KAUPTHING BANK HF	16,574,778.03
KAUPTHING BANK HF	660,000.00
Landsbanki Islands HF	5,171,330.75
Landsbanki Islands HF	7,094,005.00
Landsbanki Islands HF	6,370,000.00
Lehman Brothers Holdings Inc.	30,000,000.00
Ca and below as of March	
Bank TuranAlem	12,000,000.00
GMAC LLC	18,000,000.00
Residential Capital LLC	30,000,000.00
Syncora Guarantee Inc.	36,000,000.00
Monolines	
Ambac Assurance Corporation	48,000,000.00
MBIA Inc	3,029,126.00
MBIA Insurance	12,000,000.00

